

Lessons from the Japanese banking crisis

Presentation by Himino Ryoza, Commissioner, Financial Services Agency,
at an on-line seminar hosted by the Financial Stability Institute of
the Bank for International Settlements, April 22, 2021

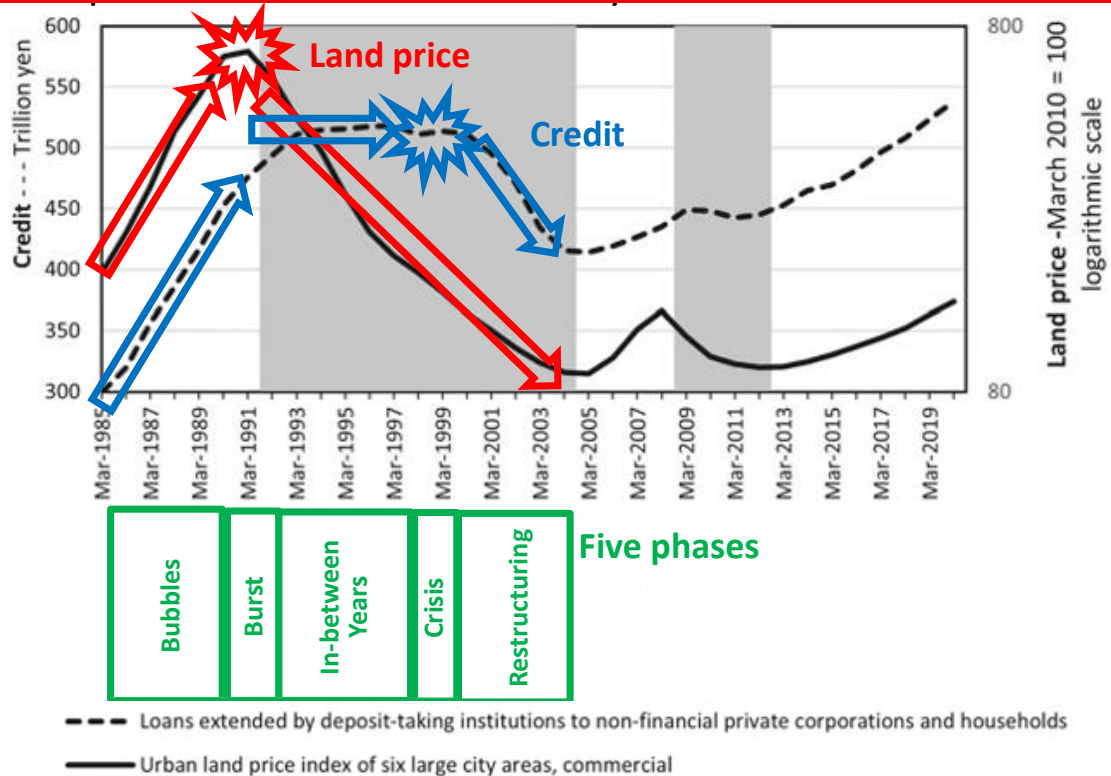
Thank you, Fernando (Restoy, Chairman, Financial Stability Institute) for your kind introduction and for giving me this opportunity to talk about lessons from the Japanese banking crisis.

The younger generation might not know, and the older generation may have already forgotten, but Japan was once the world's largest creditor country. The eight largest banks of the world were all Japanese. The Tokyo Stock Exchange had the largest market capitalization in the world, and the Osaka Stock Exchange had the third largest. The size of the Japanese economy reached 71 percent of the size of the US economy in 1995. Compare this with Chinese economy's relative size to the US one in 2019, 67 percent.

Somewhat like China today, Japan was considered as an economic threat to the United States. The cover of Time Magazine depicted a confrontation between a *sumo* wrestler and Uncle Sam, and when Sony purchased Columbia Pictures, Newsweek's cover featured the Columbia Lady wearing a *kimono*, with the headline "Japan Invades Hollywood."

Japanese people felt that their export-led growth had reached the economic and geopolitical limit and tried to transform their economy to a domestic demand-led one. Raghuram Rajan said in his book *Fault Lines*, "What is particularly alarming for the future of countries following this path [of dependence on exports for growth] is that Japan did try to change, but without success."

Japan's 1986-2004 financial cycle

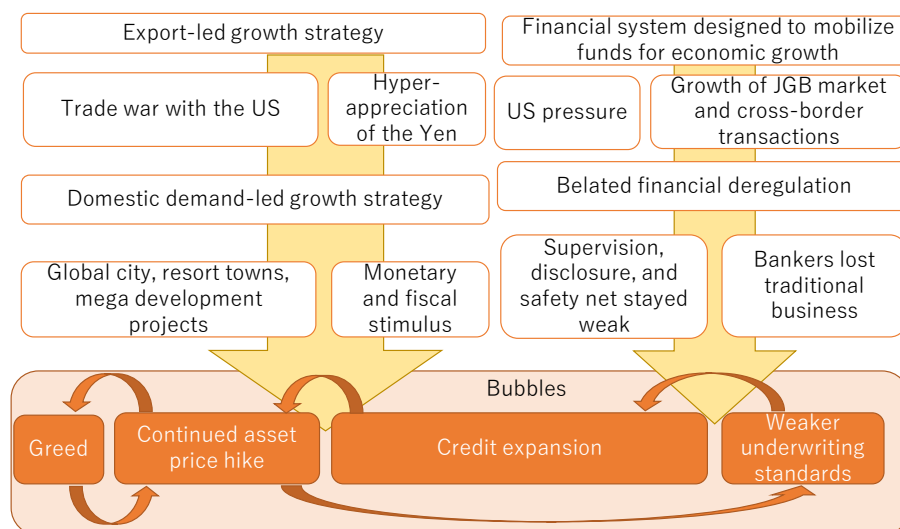


During Japan's 1986-2004 financial cycle, land prices went up, peaked, and declined. Credit to the non-financial sector went up, stayed, and after the banking crisis, declined. The combination of the two trajectories allows us to distinguish five phases: bubbles, their burst, the in-between years, crisis, and restructuring. Let me go through them one by one.

Phase 1: Bubbles

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Trade war, strong yen, global city, and deregulation



The first phase was the formation of the bubbles. Facing the possibility of a trade war with the United States and an inordinate appreciation of the yen, Japan tried to turn to a domestic demand-led growth strategy. The government coined the dreams of a global city for Tokyo and resort towns for local regions and supported mega development projects through deregulation and the sale of government owned lands.

The Japanese financial system had been designed to mobilize funds for economic growth and was highly regulated. With the pressure from the US government and with the growth of the government bond market and cross-border transactions, Japan embarked on belated financial deregulation, which should have been done anyway. But deregulation was not accompanied by necessary enhancements in supervision, disclosure, or safety nets. Deregulation in the capital markets deprived bankers of some of the traditional lending businesses and they turned to loans to real estate development projects for profits.

These Japan-specific elements were combined with the universal mechanism of a financial accelerator. Asset price hike, increased collateral values, weaker underwriting standards, credit expansion, greed, and exuberance fueled each

other. And they resulted in big bubbles.

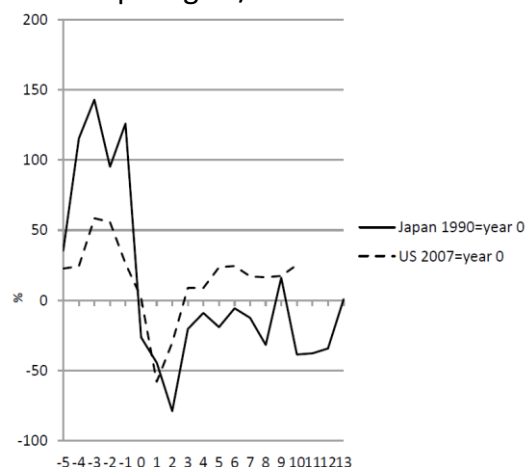
Phase 1: Bubbles

Much bigger in Japan in the 1980s than in the US in the 2000s

	Japan	US
Real estate price (peak/pre-bubble)	3.7x	1.7x
Stock price (peak/pre-bubble)	3x	1.5x
National capital gain/GDP	4.8x	1.6x

Japan absorbed the losses itself while the US transferred significant part to Europe.

National capital gain/GDP



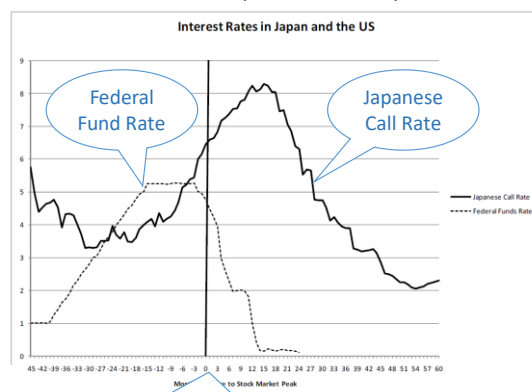
The size of the bubbles was enormous. Whether compared by i) the peak/pre-bubble multiple of real estate prices, ii) that of stock prices, or iii) the size of the national capital gain during the bubble period relative to the GDP, the Japanese bubbles in the 1980s were two to three times bigger than the bubbles in the United States in the 2000s. In addition, after the collapse of the bubbles, Japan absorbed the losses itself, while the United States transferred significant parts to Europe.

Phase 2: Pricking the bubbles

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Monetary policy

It is widely believed that Japan did too-little-too-late and that the US acted decisively and swiftly, but. . .



Months relative to stock market peak

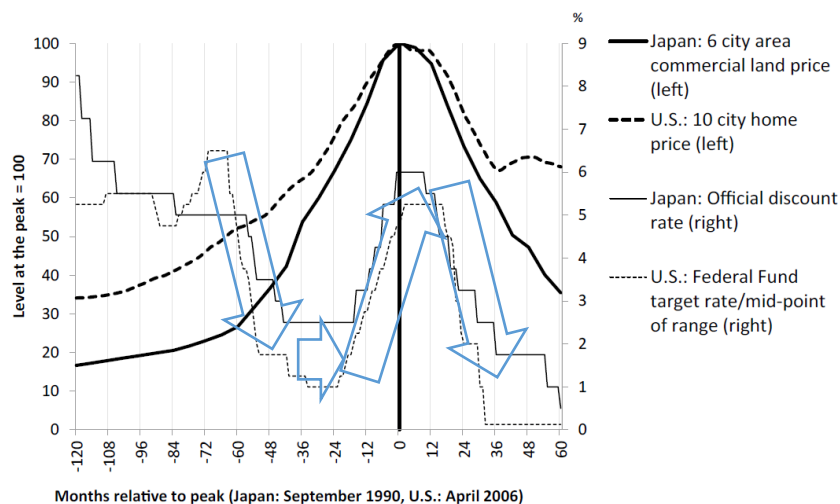
Source: Hamada, Kashyap and Weinstein (2011)

It is widely believed that, in addressing the bubbles, Japan did too-little-too-late while the United States acted decisively and swiftly. For example, Hamada, Kashyap, and Weinstein¹ used the stock market peak dates as benchmarks and compared the trajectories of policy rates in the two countries. It appears that the Federal Reserve moved preemptively and the Bank of Japan belatedly.

¹ Hamada, K., Kashyap, A., & Weinstein, D. (2011). Introduction. In K. Hamada, A. Kashyap, & D. Weinstein (Eds.), *Japan's bubble, deflation, and long-term stagnation*. Cambridge: The MIT Press.

Phase 2: Pricking the bubbles

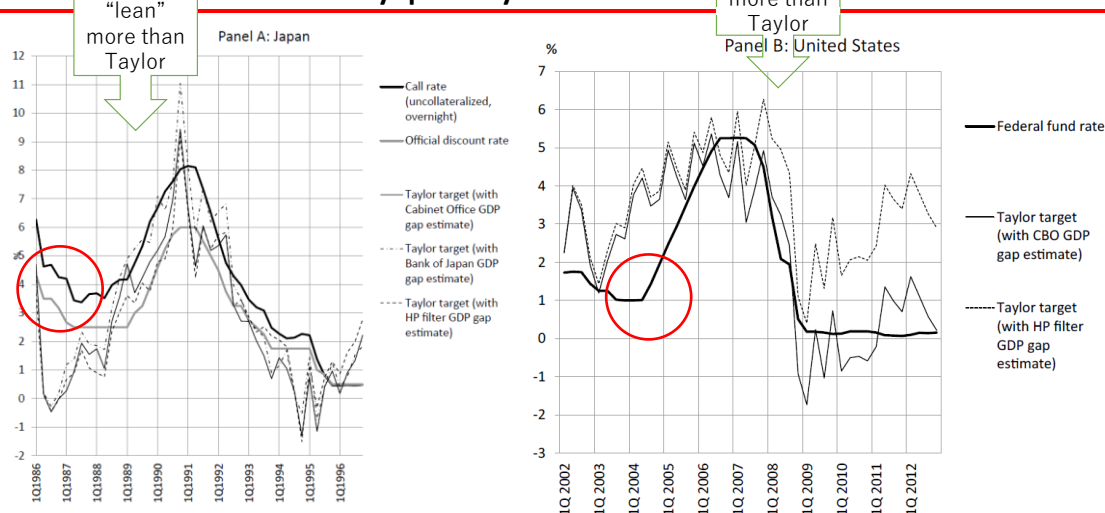
Monetary policy



But what matters most for financial stability is not stock prices but real estate prices. The graph using the real estate price peak dates as benchmarks shows that the two central banks both cut the policy rates aggressively in the early phase of the bubbles, kept them low as the bubbles grew, raised them rapidly only toward the end of the bubbles, and started to cut the rates only after the real estate prices peaked out. The two trajectories look much the same.

Phase 2: Pricking the bubbles

Monetary policy



Rather than just looking at the absolute level of the policy rates, you may want to also see if the central banks tightened or eased more than justified by the inflation and GDP gaps. I have compared the actual policy rates (thick lines) with the target levels suggested by the 1993 version of the Taylor rule, using several different GDP gap estimates (thin lines).

Though Ben Bernanke argued in Jackson Hole in 2003 that Japan engaged in a harmful effort to intentionally prick the bubbles in 1989, Japan did not “lean against the wind”² more than the Taylor targets. The only major deviation from Taylor was that it did not cut the rate enough in addressing the deflationary impacts of the rapid appreciation of the yen in 1986.

On the other hand, though the Federal Reserve advocated the “clean-up-the-mess-afterwards” type of view, it did not clean up more than the Taylor targets. The major deviation was that it did not tighten enough in the early phase of the bubbles, in 2004.

Judging from papers and speeches by Federal Reserve officials, they studied the Japanese episode carefully and were determined not to repeat the mistakes

² On leaning against the wind and cleaning up the mess afterwards, or the two approaches to monetary policy in relation to financial imbalances, see White, W. R. (2009). *Should monetary policy ‘lean or clean’?* (Federal Reserve Bank of Dallas, Globalization and Monetary Policy Institute Working Paper No. 34).

Japan had made. Sometimes firm determination and sincere efforts not to repeat others' mistakes are not enough to avoid repeating. I call this phenomenon a Greek tragedy.

Phase 2: Pricking the bubbles

Prudential policy

Table 3.1 Guidance issued by the Ministry of Finance and the Bankers' Association

April 1986	Circular issued by the Ministry of Finance	Request to behave so as not to attract criticism that banks are encouraging speculative land deals Reporting requirements on land-related lending to real estate and construction industries
December	Circular issued by the Ministry of Finance	Request to strictly refrain from financing short-term resale of lands
July 1987	Extraordinary interviews conducted by the Ministry of Finance	Interviews on lending terms with banks making large amount of loans in regions showing conspicuous rise in land prices
	"Common understanding" published by the Bankers' Association	Confirmation that land-related lending attitude shall be strictly rectified
October	Circular issued by the Ministry of Finance	Request to be without flaws in not making loans to finance speculative land transactions Request to make sure that affiliated non-bank lenders shall do the same
	Bankers' Association's voluntary rules	Elimination of lending to finance speculative land transactions
October 1989	Circular issued by the Ministry of Finance	Expansion of the scope of extraordinary interviews Reporting requirements on lending to non-bank lenders Mobilize on-site inspections to contain lending to finance real estate speculations
March 1990	Circular issued by the Ministry of Finance	Quantitative Restriction Circular

Note: The underlined measure is quantitative, while others are qualitative
Source: Banking Bureau (1989, 1991)

Started to act at a very early phase of the bubbles

Added layers of qualitative guidance

Bubbles peaked out

Resorted to quantitative guidance and deepened the busts

Table 3.2 Supervisory guidance issued by US authorities

March 1999	Interagency Guidance for Subprime Lending
October	Interagency Guidance on High Loan-to-Value (LTV) Residential Real Estate Lending
December	Interagency Guidance on Asset Securitization Activities
January 2001	Expanded Guidance for Subprime Lending Programs
February 2003	Interagency Advisory on Mortgage Banking
October	Interagency Guidance on Independent Appraisal and Evaluation Functions
April 2004	Interagency Guidance on Unfair or Deceptive Acts or Practices by State-Chartered Banks
February 2005	Interagency Guidance on the Detection, Investigation, and Deterrence of Mortgage Loan Fraud Involving Third Parties
March	Interagency FAQs on the Agencies' Appraisal Regulations and Interagency Statement on Independence of Appraisal and Evaluation Functions
May	Interagency Credit Risk Management Guidance for Home Equity Lending
May	Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans
September	Interagency FAQs on Residential Tract Development Lending
October 2006	Interagency Guidance on Nontraditional Mortgage Product Risks
October	Addendum to the May 2005 Interagency Credit Risk Management Guidance for Home Equity Lending
December	Interagency Guidance on Concentration in Commercial Real Estate Lending, Sound Risk Management Practices
June 2007	Statement on Subprime Mortgage Lending

The prudential policy trajectories during the two episodes also resemble each other. The chart on the left of the slide lists measures taken in Japan in the 1980s, and that on the right in the United States in the 2000s. Regulators in both countries started to act early in the bubbles, added layers of qualitative measures as the bubbles grew, and resorted to quantitative guidance only after peaking out of the bubbles, finishing off the bubbles and deepening the bust.

Phase 3: In-between years

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By far the longest

Table 4.1 In-between years in major banking crisis episodes since 1990

Country	Outbreak of banking crisis (A)	Residential real estate price peak (B)	Commercial real estate price peak (C)	B – A	C – A	Four-year cumulative output loss as percent of the trend GDP
Finland	1991	1989		2		69.6
Norway	1991	1988		3		5.1
Sweden	1991	1991		0		32.9
Japan	1997	1991	1990	6	7	45.0
United Kingdom	2007	2007		0		25.3
United States	2007	2006	2007	1	0	30.0
Denmark	2008	2007	2008	1	0	35.0
Ireland	2008	2007		1		107.7
Netherlands	2008	2008		0		26.1
Spain	2008	2007		1		38.8

Note Banking crises in advanced economies since 1990 for which real estate price peak years can be identified

Source For the crisis years and the output losses, Laeven and Valencia (2018). For the real estate price peak years, Bank for International Settlements, Long-term series on nominal residential property prices, and Commercial property price statistics

In the Japanese case, there was a long in-between period, between the asset price peak and the systemic banking crisis, lasting as long as seven years. This is by far the longest. The chart on the slide shows banking crises in advanced economies since 1990 for which real estate price peak years can be identified. Most crises happened in the year of the peak or the following year. The seven-year interval is exceptionally long.

One key factor behind this long in-between period is the choice made by the Japanese authorities in 1992, or the second year of the in-between period. In 1992, the Bank of Japan and the prime minister argued for an immediate clean-up of bad loans using public support. But the Ministry of Finance, which then was the banking regulator, chose to resort to banks' multi-year profits and latent gain on equities to resolve bad loans. The Ministry believed that the use of a public backstop could not be approved by the nation till banks' resources were truly exhausted and depositors realized that they were in danger.

Phase 3: In-between years

How much did it cost in reality?

284 trillion yen (60% of the annual GDP) Capital loss to the corporate sector (FY1992-2004)	
96 trillion yen (20%) Credit cost to the banking sector	Corporate sector' annual profit, realization of the latent capital gain accumulated during the post-WWII period, and own capital
31 trillion yen (6%) Public support /resolution cost	Banks' annual profit, realization of the latent capital gain, and own capital
10 trillion yen (2%) Direct cost to taxpayers	Injected capital repaid, deposit insurance premium

Significant part of the losses were covered by annual profits of borrowers and banks and annual deposit insurance premiums

In assessing this judgement, let us first look at how much it cost in reality. The corporate sector suffered capital losses amounting to around 300 trillion yen, or 60 percent of the annual GDP. Two-thirds of this were covered by the sector's annual profits, realization of the latent capital gains painfully accumulated over years since the end of the World War II, and its own capital. Around one-third, or 100 trillion yen, resulted in credit costs to the banking sector. Again, two-thirds of this were covered by banks' annual profits, realization of the latent capital gains, and own capital. The residual one-third, or 31 trillion yen, had to be covered by public support to banks or as the cost to resolve banks. But two-thirds of the 31 trillion yen did not incur a loss to taxpayers, as most of the public capital injection programs resulted in profits in aggregate and deposit insurance premiums contributed by banks were used for part of the resolution cost. The direct cost to taxpayers were 10 trillion yen, or 2 percent of the annual GDP.

In short, a significant part of the losses was covered by the annual profits of borrowers and banks and annual deposit insurance premiums over the years. Under the immediate clean-up scenario, these would not have been available.

What if all bad loans were cleaned up and losses were recognized in 1992? No such counterfactual simulation would be sufficiently credible, but let me try a wild speculation. I suppose that an immediate systemic banking crisis would

have occurred and the length of the in-between period would have been in line with other episodes, rather than seven years.

Japan would have suffered from smaller clean-up costs, as zombies would not have been allowed to stay and grow for years. But, in my view, the aggregate cost for the banking sector would not have been dramatically smaller. I looked at the changes during the bubble period in the balance sheets of the three sectors (real estate, construction, and distribution), which were the largest sources of bad loans. These changes alone explain the 100 trillion-yen credit cost to banks.

The direct cost to be borne by taxpayers to save the financial system must have been much bigger, because annual profits of borrowers and banks and annual deposit insurance premiums could not have been counted. The risk of not being able to enlist public support would thus have been greater. This could have led to an uncontrollable systemic meltdown, with a major spillover to the global financial system.

We would have seen a bigger jump in unemployment and suicide cases. In 1998, the crisis year, the number of suicide cases jumped by ten thousand and stayed at the level for a decade. In the counterfactual case, even more lives might have been lost, and a bigger national divide could have occurred. On the other hand, perhaps the biggest merit of an immediate clean-up scenario would have been Japan being able to use the 1990s and the 2000s to design the future rather than to clean-up the past.

Phase 4: Crisis

There are many episodes and lessons to talk about from the crisis period between late 1997 and early 1999, but given the limited time available, let me focus only on one aspect.

After the Global Financial Crisis, the United States and Europe chose to cut back on the public backstop and, thereby, prevent moral hazard. On the other hand, after the Japanese banking crisis, Japan kept a strong public backstop while pursuing the criminal, civil, and moral responsibilities of bankers and

borrowers.

In Japan, 44 former CEOs, 63 non-CEO executives, and 27 staff members from 37 failed financial institutions were arrested. 460 debtors were criminally charged for disturbing the collection of debts in 240 cases.

My hunch is that the Japanese choice have worked to contain moral hazard and a recurrence of exuberance more effectively.

Phase 5: Restructuring banks and borrowers

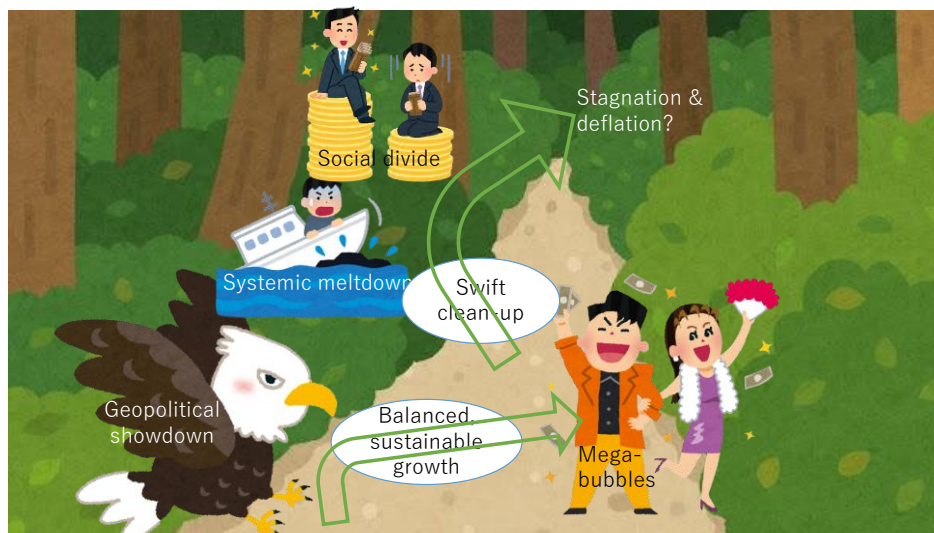
The systemic crisis was contained with the introduction of strong resolution tools, public backstop funding, enhanced accounting and regulatory standards, and a new supervisory agency (the JFSA), but even after this, Japan needed five more years from March 1999 to March 2004 to fully clean up the problems and to sever the vicious cycle between the real economy and the financial system.

The JFSA conducted three waves of on-sight review of banks' asset quality and set rules and targets to make banks remove bad loans from their balance sheets. These resulted in the resolution of 117 deposit taking institutions. They also required restructuring of insolvent but viable borrower firms and liquidation of firms without viable business plans. New players, such as the Industrial Revitalization Corporation, the SME Business Rehabilitation Support Co-operatives, and loan servicers, were created, and new procedures, such as the Civil Rehabilitation Law, the Revised Corporate Reorganization Act, and the Guidelines for Multi-Creditor Out-of-Court Workout, were introduced.³

These tools were modified after the Global Financial Crisis in 2008 and again after the Great East Japan Earthquake in 2011. They can be expected to contribute towards addressing debt overhang and unviable firms in the post-COVID era, though further refinements may be needed to address the COVID-specific factors, such as the potentially larger number of cases.

³ For more on these new players and processes, see [Chapter 6](#) of Himino, R. (2020). *The Japanese Banking Crisis*. Palgrave Macmillan.

How not to repeat these?



Before concluding, let me briefly recap the story and discuss how we can avoid repeating these in the future. Japan pursued an export-led growth strategy but, facing the risk of a geopolitical showdown, changed its course. It would have been better if Japan had been able to shift to a balanced and sustainable growth path, but it made an overrun and created bubbles of a gigantic size. Japan wanted to clean up the mess swiftly after the burst of the bubbles but, given the size of the bubbles and the lack of a public backstop, the authorities thought that such action would run the risk of a systemic meltdown and a big social divide. Japan chose to take time, and stagnation and deflation ensued. It did, however, avoid a systemic meltdown despite bubbles two to three times bigger than the US ones. Some argue that the aftermath of the Global Financial Crisis has fueled populism in many parts of the world, but in the Japanese society, the populist overtone is reasonably contained even today.

I do not have any silver bullet which will promise a better outcome, but I think three things may help. First, looking through the cycle in making policy choices at each phase. Second, paying attention to wider political economy considerations. Third, having a strong standing public backstop, the benefit of which may outweigh the risk of moral hazard, which can be contained by other means.

I recently published what I talked about in a series of lectures to regulators from emerging economies and developing countries at the JFSA's Global Financial Partnership Center (GLOPAC). The book, *The Japanese Banking Crisis*, is open access and available for free in PDF and EPUB formats at the [SpringerLink website](#).

Thank you for your attention.